

**POOLING AND UNITIZATION IN VIRGINIA:
THE LAW, THE REGULATIONS
AND THE REALITY***

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Introduction

The explosion of interest in coalbed methane as an unconventional fuel source was a key factor in the adoption of the Virginia Gas & Oil Act of 1990. It is fair to say that the 1990 Act and the Regulations promulgated thereunder are extremely innovative in the handling of concurrent development issues, particularly in the area of pooling and unitization. For example, Virginia creatively side steps the issue of conflicting claims to coalbed methane ownership through an escrow mechanism which sets aside proceeds from coalbed methane wells. This approach enables production not to be hindered or halted while conflicting ownership rights are being litigated.

Permitting wells, pooling of interests and unitization under the new Act have not been free from frustration during the last two years. Initially, the Virginia Gas and Oil Board, the gas and oil regulatory arm under the Department of Mines, Minerals and Energy was nearly paralyzed with the logjam created by numerous applications and conflicting interpretations of the new law. In the past two years, however, the Board and the gas and oil industry and their counsel have made great strides in interpreting the Act and in promulgating Regulations under the Act. Permit applications, applications for field rules, pooling and unitization are now being handled much more smoothly and efficiently.

A key element in the gas and oil regulatory process in Virginia has been the promulgation and implementation of Regulations under the 1990 Act. In addition, the Board and the industry have worked together in developing creative field rules, drilling units and forced pooling orders to deal with concurrent and conflicting use problems, especially in the area of coalbed methane and gob gas production. On the other hand, Virginia's heavy hand in regulating gas and oil development has lead

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to much frustration in the industry and complaints that development in Virginia is not profitable as it could be or should be.

While the Virginia legislature and the Department of Mines, Minerals and Energy may have initially threatened the economics of mineral development in Virginia, the Gas and Oil Board, working in conjunction with the industry, has proven it is willing and capable of fashioning field rules, drilling units and pooling orders that both balance the concerns of the legislature and the gas and oil industry. Virginia has recently experienced very positive advances in the fashioning of creative and economically viable unitization and poolings of interests.

The Law

Unlike many states, Virginia does not have unitization by legislation. Because of Virginia's terrain and its concurrent development of coal, the legislature has not dictated unit sizes and locations. Instead, field rules and drilling units, along with orders for the pooling of interests in drilling units, are created upon application as the development arises. The following is an outline of the portions of the Virginia Gas and Oil Act dealing with creation of field rules, drilling units and pooling of interests.

Virginia Code Section 45.1-361.20. Field Rules and Drilling Units for Wells

The Gas and Oil Board on its own motion, or the gas or oil owner upon application, may establish or modify drilling units. To the extent reasonably possible, drilling units are to be of uniform shape and size for an entire pool. Owners may also apply to the Board for the establishment of field rules and the creation of drilling units for the field.

At the hearing regarding the establishment or modification of drilling units, the Board shall make the following determinations:

1. Whether the proposed drilling unit is an unreasonable or arbitrary exercise of the gas or oil owners right to explore for or produce gas or oil.
2. Whether the proposal would unreasonably interfere with the present or future mining of coal or other minerals.
3. The acreage to be included in the order.
4. The acreage to be embraced within each drilling unit and the shape thereof.
5. The area in which wells may be drilled on each unit.
6. The allowable production of each well.

For coalbed methane gas well drilling units, the Board requires that the drilling units conform to the mine development plan, if any, and if requested by the coal operator, well spacing shall correspond with mine operations, including the drilling of multiple coalbed methane gas wells on each drilling unit.

Coal owners have built in objections. If any drilling unit will allow a well to be drilled into or through a coal seam, any coal owner within the area covered by the drilling unit may object to the establishment of the drilling unit. The Board will consider the objection in accordance with the provisions of Sections 45.1-361.11 and 45.1-361.12. Section 361.11 sets forth the objections that may be made by a coal owner to an application for a gas well permit. Section 361.12 establishes the right of coal owners to object to any well that will be within 2,500 feet of any existing or permitted well. This is euphemistically known as the coal owner veto.

After the field or spacing order has been entered creating drilling units or a pattern of drilling units for a pool, the Board may on its own motion or by application of an interested party, extend the pool or the pattern of drilling outside of the initial area.

Virginia Code Section 45.1-361.21. Pooling of Interests in Drilling Units.

The Board, upon application from any gas or oil owner shall enter an order pooling all interests in the drilling units for the development and operation thereof when:

1. Two or more separately owned tracts are embraced in a drilling unit;
2. There are separately owned interests in all or part of any such drilling unit and those having interests have not agreed to pool their interests; or
3. There are separately owned tracts embraced within the minimum statewide spacing requirements prescribed in Section 45.1-361.17 (1,320 feet for oil wells and 2,640 feet for gas wells).

All pooling orders entered by the Board are required to contain the following information:

1. The time and date when such order expires.
2. The gas or oil owner who is authorized to drill and operate the well; for coalbed methane wells the designated operators must have the right to conduct operations or have the written consent of owners with the right to conduct operations on at least twenty-five percent of the acreage included in the unit.
3. The conditions under which gas or oil owners may become participating operators or exercise their rights of election to participate or have a carried interest.
4. The sharing of all reasonable costs, including a reasonable supervision fee, between participating operators.
5. The order shall also require that non-leasing gas or oil owners be provided with reasonable access to unit records submitted to the director or inspector.
6. The order must also establish a procedure for a gas or oil owner who received notice of the hearing and who does not decide to become a participating operator whereby the operator may elect to (i) sell or lease his gas or oil ownership to a participating operator (ii) enter into a voluntary agreement to share in the operation of the well at a

rate of payment mutually agreed to by the gas or oil owner and the gas or oil operator authorized to drill the well or (iii) share the operation of the well as a non-participating operator on a carried basis after the proceeds allocable to his share equal the following:

(a) in the case of a leased tract 300% of the share of such costs allocable to his interest; or

(b) in the case of an unleased tract 200% of the share of such costs allocable to his interest.

If any gas or oil owner remains unknown or unidentified after the establishment of a pooling order, they are deemed to have elected to lease their interest to the gas or oil operator at a rate to be established by the Board. The Board will establish an escrow account into which the unknown lessors' shares of proceeds shall be paid and to be held for their benefit. If unclaimed, the escrowed proceeds shall be disposed of under the Uniformed Disposition of Unclaimed Property Act.

The Board shall resolve all disputes arising among gas or oil operators regarding the amount and reasonableness of well operation costs.

Section 45.1-361.22 Pooling of Interests for Coalbed Methane Gas Wells; Conflicting Claims to Ownership

When there are conflicting claims to the ownership of coalbed methane gas, the Board, upon application from any claimant, shall enter an order pooling all interests or estates in the coalbed methane gas drilling unit for the development and operation thereof. In addition to the provisions of Section 45.1-361.21, the following provisions shall apply:

1. Notice shall be given to each person identified by the applicant as a potential owner of interest in the coalbed methane gas.

2. The Board shall establish an escrow account into which payment for costs or proceeds attributable to the conflicting interests shall be deposited and held for the interest of the claimants.
3. The coalbed methane gas operator shall deposit into the escrow account any money paid by a person claiming a contested ownership interest as a participating operator's share of costs pursuant to the provisions of Section 361.21.
4. The coalbed methane gas operator shall deposit into the escrow account 1/8 of all proceeds attributable to the conflicting interests plus all proceeds in excess of ongoing operational expenses as provided for under Section 361.21.
5. The Board shall order payment of principal and accrued interest from the escrow account to all persons legally entitled thereto pursuant to the provisions of Section 361.21.
6. Any person who does not make an election under the pooling order shall be deemed, subject to a final legal determination of ownership, to have leased his gas or oil interests to the coalbed methane gas operator as the pooling order may provide.

The Regulations

Virginia operated under emergency regulations promulgated under the 1990 Act for about one year. Soon after the 1990 Act came into effect, however, the Department of Mines, Minerals and Energy and industry representatives began working together to formulate permanent regulations. After much hue and outcry from the industry over the original proposed regulations, the Department of Mines, Minerals and Energy responded by drafting new regulations that addressed many of the concerns raised by the industry. The regulations governing Articles 1 and 2 of the 1990 Act became effective in the fall of 1991.

The following are the highlights of Virginia Gas and Oil Board Regulation VR480-05-22.2 as they relate to pooling and unitization.

Applications for Field Rules

This section of the Regulations sets forth the details and specifics required to be contained in an application for field rules, such as:

1. The name and address of the applicant and the applicant's counsel.
2. Statement of the relief sought.
3. Citations of statutes, rules, orders and deciding cases supporting the relief sought.
4. Statement of the type of field and a description of the proposed formation or formations subject to the petition, as well as a description of the pool or pools included in the field based on geological and technical data.
5. Statement of the amount of acreage to be included in the order.
6. Statement of the proposed allowable production rate or rates and supporting documentation.
7. Evidence that any proposal to establish or modify a unit or units for coalbed methane gas will meet the requirements of 361.20.C. This section requires that coalbed methane drilling units conform to the mine development plan and that well spacing shall correspond to coal mine operations.
8. An affidavit demonstrating that due diligence was used to locate and serve persons required to be served with notice.
9. Proof of notice of publication when required.
10. Twelve copies of proposed exhibits.

Applications for Exceptions to Minimum Well-Spacing Requirements

This section provides the specific requirements needed in making an application for exception to statewide spacing as set forth in 45.1-361.17. Requirements include the following:

1. Name and address of applicant and applicant's counsel, if any.
2. In the case of an application for an exception to spacing established in a field rule, identification of the order governing spacing in a field.
3. Statement of the proposed location of the well in relation to permitted wells within the distances prescribed in Section 361.17.
4. Description of the formation of formations to be produced from the well.
5. A description of the spacing of other wells producing from the formation or formations to be produced by the well.
6. A description of the conditions justifying alternative spacing.
7. An affidavit demonstrating that due diligence was used to locate and serve persons required to be served.
8. Proof of notice of publication, when required.
9. Copies of proposed exhibits.

Applications to Pool Interests in a Drilling Unit: Conventional Gas or Oil or No Conflicting Claims to Coalbed Methane Gas Ownership

1. Applications to pool interests in a drilling unit for conventional gas or oil under Section 361.21 where there is no conflicting claims to ownership to claims of coalbed methane gas must contain the same sort of information as listed immediately above. For an application to pool a coalbed methane gas unit, a statement of the percentage of total interest held by the applicant is

required, as well as the names and owners of the percentage of interests to be escrowed under Section 361.21D.

2. Applications to amend an order pooling interests in a drilling unit may be filed by written stipulation of all persons affected. In this instance, there is no requirement for the normal specific information cited in the sections above.
3. The unit operator is required to file an affidavit with the Board stating the elections that have been made under Section 361.21. If no elections were made or any response was untimely, the affidavit shall state this information.

Applications to Pool Interests in a Drilling Unit: Conflicting Claims to Coalbed Methane Ownership

Applications filed under Section 361.22 to pool interests in a drilling unit for coalbed methane gas where there are conflicting claims to ownership of the coalbed methane gas shall contain a description of the conflicting ownership claims and the percentage of interest to be escrowed for the conflicting claims, and a plan for escrowing the costs of drilling and operating the well or wells and the proceeds from the well or wells attributable to the conflicting interests.

Standards for Escrow Accounts

The mechanics for the operation of the escrow accounts are established by order of the Board on a case-by-case basis.

Allowable Costs Which May Be Shared in Pooled Gas or Oil Operations

The unit operator of a pooled unit may share all reasonable costs of operating the unit, including a reasonable supervision fee, with other participating and non-participating operators, as provided for in Section 361.21. These costs may include the following:

Direct Costs

- ecological and environmental
- rentals and royalties
- labor
- employee benefits
- material
- transportation services
- equipment and facilities furnished by the unit operator
- damages and losses to joint property
- legal expenses
- taxes
- insurance
- abandonment and reclamation
- communications and other expenditures

Indirect Charges

- drilling and production operations
- major construction
- catastrophe

Where there are conflicting royalty claims to coalbed methane gas, the unit operator of a forced pooled coalbed methane gas unit shall deposit proceeds in accordance with Section 361.22 to be determined at the well head.

Where there are conflicting claims and one or more persons have elected to become participating or non-participating operators, the unit operator of a forced pooled coalbed gas unit shall escrow net proceeds after deduction of royalties and other costs consistent with the terms of this regulation and the Board's order regarding the unit.

In disputes regarding a unit operator's costs, the unit operator is entitled to the benefit of a presumption of reasonableness as to the types of costs being disputed. The unit operator is not entitled to a presumption of reasonableness as to the amount of costs being disputed.

The Reality

Although the 1990 Virginia Gas and Oil Act is clearly innovative and forward thinking in its handling of conflicting use issues, particularly with respect to coalbed methane, real world challenges and development problems naturally do not always fit neatly within the confines of the law. The Regulations, which were drafted during the year following the enactment of the 1990 Act, represent an effort by the Department of Mines, Minerals and Energy and the industry to smooth some of the rough edges of the 1990 Act to meet the reality of gas and oil development in Virginia. But the greatest strides in paving the way for efficient development in Virginia have been made by the hard work by an active and thoughtful Gas and Oil Board, in conjunction with the industry and their counsel appearing before the Board.

Initially, the Virginia Gas and Oil Board was paralyzed by the logjam created by implementation of the new Act. No one was quite sure how the new mechanics worked. One of the biggest concerns was the plight of conventional gas and oil owners who saw massive coalbed methane development as a potential lockout of their rights to development conventional gas and oil at a later date. In Virginia, coal owners are entitled to an automatic veto of any well to be placed within 2,500 feet of an existing or permitted well, pursuant to Section 361.12. If coalbed methane developers dot an entire coalbed methane gas field with wells on 80 acres spacing, the potential

effect on conventional gas and oil owners in trying to find locations later for their wells could be devastating. Given the 2,500 foot veto rule, there may not be any space available for conventional gas or oil wells later. This issue was presented to the Board and wrangled over for many months in 1990 and 1991. But the Board eventually ruled that mineral owners must proceed on a first come first served basis. If conventional owners want to insure the location of potential well sites, they must get on with their development plans and get their wells permitted. The Board in effect said that it will deal with conflicting use problems and potential lockout problems if and when they arise.

One suggestion to deal with this problem has been for the Board to consider coalbed methane wells that merely penetrate but do not pass entirely through the coal seam to be considered as a vertical ventilation hole and not as a "existing or permitted well" within the meaning of Section 361.12. This would enable a conventional gas and oil owner to place a conventional well within 2,500 feet of a coalbed methane well/vertical ventilation hole without the threat of a 2,500 foot veto. This potential method of preserving the rights of conventional gas and oil owners has not yet been presented to the Board by the filing of a conventional gas or oil well permit within 2,500 feet of a coalbed methane well.

The Board and the industry next turned to the business of getting on with development of coalbed methane gas fields. As with any new endeavor, the learning curve was very steep. The Board and the industry discovered creative ways of dealing with real world development issues.

The industry soon recognized that in coalbed methane development there are really three phases:

1. The initial phase when coalbed methane production occurs in areas where coal mining has not yet commenced or where active coal mines have not yet been distressed;
2. The active gob phase when coal seams have been distressed creating the need for active gob wells; and

3. The sealed phase when all coal mining is concluded and it may make sense to seal off a group of longwall panels for the purpose of more efficiently and fairly pooling coalbed methane gas interests.

Three operators in Virginia who have been active in coalbed methane development are Equitable Resources Exploration, Inc., Oxy USA, Inc. and the Pocahontas Gas Partnership. These operators and their counsel have been very creative in fashioning plans for spacing, unitization and pooling of interests for coalbed methane development in Virginia. The result has been the implementation of innovative orders issued by the Gas and Oil Board for different types of production drilling units and the pooling of coalbed methane gas interests.

The Initial Phase

Equitable Resources was the first to jump into the coalbed methane development foray when it presented and won approval for creation of the Nora Coalbed Methane Gas Field. Oxy next established the Oakwood Coalbed Methane Gas Field. Both fields contemplated the initial phase of coalbed methane development only, and gob well gas production was not addressed at all in either order. The Oakwood field rules allow the permitting of coalbed methane gas wells on a grid pattern with 80 acre spacing. Since the passage of these field rules, Equitable Resources and Oxy have been very active in permitting coalbed methane gas wells throughout the Nora and Oakwood fields.

Active Gob Gas Well Production

The Pocahontas Gas Partnership ("PGP"), a partnership between Consolidation Coal Company and Conoco, jumped in the foray of coalbed methane development in 1991. Recognizing the benefits of coalbed methane development in areas where active coal mining is occurring or has recently concluded, the PGP has achieved the establishment of creative orders for production units for the production of coalbed methane gas from active and unsealed gob areas. Indeed, as of April

of this year, the PGP has been successful in achieving the creation of twelve production units for the production of coalbed methane gas from active and unsealed gob areas.

The gob gas production in these drilling units will occur from the base of the Pocahontas No. 2 coal seam upward to and result in common communication of all seams and areas below the tiller seam of coal. The production units are ordered to conform to the existing mine plans used by Consolidation Coal Company in its Buchanan No. 1 mine. The production units vary in the number of wells allowed to be permitted to have a produce from the units.

The orders also grant relief from the Oakwood coalbed methane gas field with respect to spacing. Under the PGP production unit orders, coalbed methane wells shall be located no closer than 300 feet from any boundary of any subject drilling units and no coalbed methane well shall be located closer than 300 feet from any other coalbed methane well. PGP is also permitted to locate the maximum number of coalbed methane wells which may be located in any of the subject drilling units while maintaining compliance with the well spacing requirements mentioned above. PGP is also permitted to convert vertical ventilation holes to coalbed methane wells for purposes of production in these units.

In May 1992, Oxy also achieved the establishment of a creative order for drilling units for production of unsealed gob gas, short hole gas and any additional well authorized by the Act. Short hole gas, as defined in Oxy's application, is coalbed methane gas produced from subsurface boreholes which are drilled horizontally into a longwall panel. Oxy, which is engaged in coalbed methane development in connection with the coal mining plans of Island Creek Coal Company, is carefully planning its coalbed methane development in a way that will allow Island Creek to later maximize its coal mining and increase safety.

The Oxy production order establishes 80 acre drilling units and establishes a unique method for calculation of production, revenue and costs for short hole, unsealed gob and additional well production of coalbed methane gas. The operator shall calculate production and revenue based upon

the mine plan being implemented within each affected 80 acre drilling unit and in particular, based upon the surface acreage in each 80 acre drilling unit actually contained within a longwall panel as shown on the applicable mine plan. The formula for division of interest for production from any 80 acre drilling unit affected by a longwall panel and from any separately owned tract in any 80 acre unit is made based upon whether the gas is short hole, unsealed gob or gas from any additional well.

In the initial phase of coalbed methane development, the gas is produced and royalty owners are paid on drainage out of the acreage contained in the drilling units. When wells are converted from coalbed methane to gob gas wells, the gas is generally produced from a longwall panel instead of the drilling unit acreage, because obviously in order to have gob gas, the mining must be active. Accordingly, there are challenging questions relating to fair assessment of production, revenue and costs to royalty owners when a coalbed methane well is converted to a gob gas well.

The PGP and Oxy have developed different methods of dealing with this issue. Generally, the PGP plan calls for dividing the production, revenue and costs among royalty owners contained within a longwall panel where mining is active. Oxy, however, basis its mathematical calculation for the division of production, revenue and costs on the specific acreage within an 80 acre unit under which the longwall panel being degassed lies.

Sealed Coalbed Methane Gob Gas Production

The PGP and Oxy have also been successful in establishing orders creating the formation of production units for sealed coalbed methane gob gas. These orders establish units and boundaries of pools for production of sealed coalbed methane gob gas from the sealed mined-out gob areas, separate and distinct from and not in communication with any other common accumulation of sealed coalbed methane gob gas.

PGP has successfully obtained three separate orders for the creation of production units from sealed coalbed methane gob areas. The sealed areas consist of varying numbers of longwall panels.

One of the orders creates a sealed area from four longwall panels, one from ten longwall panels, and another from eight longwall panels. The orders also permit varying numbers of vertical ventilation holes to be converted to coalbed methane wells, and the orders also allow leeway for the permitting of additional coalbed methane wells as needed to efficiently drain the sealed area of coalbed gob gas.

With respect to one of the sealed production units, PGP was able to demonstrate that it owned 100% of the oil and gas and 100% of the coalbed methane lease hold estate for the affected area. The Board also found that PGP has a unit and pooling and unit designation agreement with all of the parties involved in the subject formation underlying the sealed area. With respect to the other two sealed production units, PGP was able to obtain forced pooling orders. The forced pooling orders implement the mechanisms in Section 361.22 and provide a good example of how the new law can work.

Each owner of coalbed methane gas in the affected area was given thirty days from the date of the order to make an election of participation as called for under Section 361.22. Owners were entitled to elect the following options:

1. Participation in the working interest in and development of the coalbed methane gas in the affected area;
2. Electing to share in the operation of the wells covered in the affected area on a carried basis so that the proportioned share of the natural cost of drilling, completing, equipping, operating, plugging and abandoning of such wells allocable to such carried well operator's interest is charged against such carried well operator's share of production from such wells; or
3. In lieu of participating in the working interests, owners could receive cash consideration in the form of \$1.00 per net mineral acre owned plus a total royalty in the amount of 1/8 of 8/8ths of the coalbed methane gas condensate produced from the wells covered by the order.

Failure to make an election under the forced pooling order results, as required by the statute, in such owner having been deemed to have leased his interest in the coalbed methane gas to the designated coalbed methane gas operator.

The forced pooling order also calls for the creation of an escrow account with respect to any conflicting claims for payments of bonus, royalty or other payments, including the payment of any costs necessary to perfect the participation option. If any person refuses to accept the cash bonus consideration, the unit operator is required to deposit such cash bonus, royalty payment or other payment into the escrow account.

Conclusion

The Virginia Gas and Oil Act of 1990 is unquestionably innovative in its handling of coalbed methane development. The innovations may be most applicable to the unique concurrent use and development problems confronted in the coal rich territory of southwest Virginia. Many of the innovations, however, are broad reaching and universally applicable.

To Virginia's credit, the year-long logjam that occurred in gas and oil development in southwest Virginia following the enactment of the 1990 Act has been alleviated by the hard work of an aggressive and thoughtful Gas and Oil Board, working in conjunction with a very creative gas and oil industry. The Regulations promulgated under the 1990 Act provide maneuvering room and it is significant to note that the Department of Mines, Minerals and Energy was responsive to the many concerns raised by the industry with respect to earlier drafts presented by the Department. But the greatest strides in achieving efficient coalbed methane development, consistent with protection of correlative rights and concurrent use problems, has come at the Gas and Oil Board level. Mineral producers who were concerned, confused and befuddled by the Virginia Legislature's apparent draconian approach to mineral development should take heart in recent creative achievements experienced in Virginia over the last two years.